

§ 1.267(a)-3 Deduction of amounts owed to related foreign persons.

(a) *Purpose and scope.* This section provides rules under section 267(a) (2) and (3) governing when an amount owed to a related foreign person that is otherwise deductible under Chapter 1 may be deducted. Paragraph (b) of this section provides the general rules, and paragraph (c) of this section provides exceptions and special rules.

(b) *Deduction of amount owed to related foreign person—(1) In general.* Except as provided in paragraph (c) of this section, section 267(a)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person. An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 thus may not be deducted by the taxpayer until such amount is paid to the related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the taxpayer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines *controlled group* for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 884(f)).

(2) *Amounts covered.* This section applies to otherwise deductible amounts that are of a type described in section 871(a)(1) (A), (B) or (D), or in section 881(a) (1), (2) or (4). The rules of this section also apply to interest that is from sources outside the United States. Amounts other than interest that are from sources outside the United States, and that are not income of a related foreign person effectively connected with the conduct by such related foreign person of a trade or business within the United States, are not subject to the rules of section 267(a) (2) or (3) or this section. See paragraph (c) of this section for rules governing the treatment of amounts that are income of a

related foreign person effectively connected with the conduct of a trade or business within the United States by such related foreign person.

(3) *Change in method of accounting.* A taxpayer that uses a method of accounting other than that required by the rules of this section must change its method of accounting to conform its method to the rules of this section. The taxpayer's change in method must be made pursuant to the rules of section 446(e), the regulations thereunder, and any applicable administrative procedures prescribed by the Commissioner. Because the rules of this section prescribe a method of accounting, these rules apply in the determination of taxpayer's earnings and profits pursuant to § 1.1312-6(a).

(4) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example 1. (i) FC, a corporation incorporated in Country X, owns 100 percent of the stock of C, a domestic corporation. C uses the accrual method of accounting in computing its income and deductions, and is a calendar year taxpayer. In Year 1, C accrues an amount owed to FC for interest. C makes an actual payment of the amount owed to FC in Year 2.

(ii) Regardless of its source, the interest owed to FC is an amount to which this section applies. Pursuant to the rules of this paragraph (b), the amount owed to FC by C will not be allowable as a deduction in Year 1. Section 267 does not preclude the deduction of this amount in Year 2.

Example 2. (i) RS, a domestic corporation, is the sole shareholder of FSC, a foreign sales corporation. Both RS and FSC use the accrual method of accounting. In Year 1, RS accrues \$z owed to FSC for commissions earned by FSC in Year 1. Pursuant to the foreign sales company provisions, sections 921 through 927, a portion of this amount, \$x, is treated as effectively connected income of FSC from sources outside the United States. Accordingly, the rules of section 267(a)(3) and paragraph (b) of this section do not apply. See paragraph (c) of this section for the rules governing the treatment of amounts that are effectively connected income of FSC.

(ii) The remaining amount of the commission, \$y, is classified as exempt foreign trade income under section 923(a)(3) and is treated as income of FSC from sources outside the United States that is not effectively connected income. This amount is one to which the provisions of this section do not apply, since it is an amount other than interest from sources outside the United States and

is not effectively connected income. Therefore, a deduction for \$y is allowable to RS as of the day on which it accrues the otherwise deductible amount, without regard to section 267 (a)(2) and (a)(3) and the regulations thereunder.

(c) *Exceptions and special rules*—(1) *Effectively connected income subject to United States tax.* The provisions of section 267(a)(2) and the regulations thereunder, and not the provisions of paragraph (b) of this section, apply to an amount that is income of the related foreign person that is effectively connected with the conduct of a United States trade or business of such related foreign person. An amount described in this paragraph (c)(1) thus is allowable as a deduction as of the day on which the amount is includible in the gross income of the related foreign person as effectively connected income under sections 872(a)(2) or 882(b) (or, if later, as of the day on which the deduction would be so allowable but for section 267(a)(2)). However, this paragraph (c)(1) does not apply if the related foreign person is exempt from United States income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(2) *Items exempt from tax by treaty.* Except with respect to interest, neither paragraph (b) of this section nor section 267 (a)(2) or (a)(3) applies to any amount that is income of a related foreign person with respect to which the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits). Interest that is effectively connected income of the related foreign person under sections 872(a)(2) or 882(b) is an amount covered by paragraph (c)(1) of this section. Interest that is not effectively connected income of the related foreign person is an amount covered by paragraph (b) of this section, regardless of whether the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States.

(3) *Items subject to reduced rate of tax by treaty.* Paragraph (b) of this section applies to amounts that are income of a related foreign person with respect to which the related foreign person claims a reduced rate of United States income tax on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of royalties).

(4) *Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company*—(i) *Foreign personal holding companies.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a foreign personal holding company within the meaning of section 552, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the foreign personal holding company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the foreign personal holding company computes its taxable income and earnings and profits for purposes of sections 551 through 558. See section 551(c) and the regulations thereunder for the reporting requirements of the foreign personal holding company provisions (sections 551 through 558).

(ii) *Controlled foreign corporations.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a controlled foreign corporation within the meaning of section 957, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964. See section 6038 and the regulations thereunder for the reporting requirements of the controlled foreign corporation provisions (sections 951 through 964).

(iii) *Passive foreign investment companies.* If an amount to which paragraph (b) of this section otherwise applies is

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owed to a related foreign person that is a passive foreign investment company within the meaning of section 1296, then the amount is allowable as a deduction as of the day on which amount is includible in the income of the passive foreign investment company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the earnings and profits of the passive foreign investment company are computed for purposes of sections 1291 through 1297. See sections 1291 through 1297 and the regulations thereunder for the reporting requirements of the passive foreign investment company provisions. This exception shall apply, however, only if the person that owes the amount at issue has made and has in effect an election pursuant to section 1295 with respect to the passive foreign investment company to which the amount at issue is owed.

(iv) *Examples.* The rules of this paragraph (c)(4) may be illustrated by the following examples. Application of the provisions of sections 951 through 964 are provided for illustration only, and do not provide substantive rules concerning the operation of those provisions. The principles of these examples apply equally to the provisions of paragraphs (c)(4) (i) through (iii) of this section.

Example 1. P, a domestic corporation, owns 100 percent of the total combined voting power and value of the stock of both FC1 and FC2. P is a calendar year taxpayer that uses the accrual method of accounting in computing its income and deductions. FC1 is incorporated in Country X, and FC2 is incorporated in Country Y. FC1 and FC2 are controlled foreign corporations within the meaning of section 957, and are both calendar year taxpayers. FC1 computes its taxable income and earnings and profits, for purposes of sections 951 through 964, using the accrual method of accounting, while FC2 uses the cash method. In Year 1 FC1 has gross income of \$10,000 that is described in section 952 (a) ("subpart F income"), and which includes interest owed to FC1 by P that is described in paragraph (b) of this section and that is otherwise allowable as a deduction to P under chapter 1. The interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 2. The facts are the same as in *Example 1*, except that in Year 1 FC1 reports no subpart F income because of the application of section 954 (b)(3)(A) (the subpart F de minimis rule). Because the amount owed to

FC1 by P is includible in FC1's gross income in Year 1, the interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 3. The facts are the same as in *Example 1*. In Year 1, FC1 accrues interest owed to FC2 that would be allowable as a deduction by FC1 under chapter 1 if FC1 were a domestic corporation. The interest owed to FC2 by FC1 is paid by FC1 in Year 2. Because FC2 uses the cash method of accounting in computing its taxable income for purposes of subpart F, the interest owed by FC1 is allowable as a deduction by FC1 in Year 2, and not in Year 1.

(d) *Effective date.* The rules of this section are effective with respect to interest that is allowable as a deduction under chapter 1 (without regard to the rules of this section) in taxable years beginning after December 31, 1983, but are not effective with respect to interest that is incurred with respect to indebtedness incurred on or before September 29, 1983, or incurred after that date pursuant to a contract that was binding on that date and at all times thereafter (unless the indebtedness or the contract was renegotiated, extended, renewed, or revised after that date). The regulations in this section issued under section 267 apply to all other deductible amounts that are incurred after July 31, 1989, but do not apply to amounts that are incurred pursuant to a contract that was binding on September 29, 1983, and at all times thereafter (unless the contract was renegotiated, extended, renewed, or revised after that date).

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§ 1.267(b)-1 Relationships.

(a) *In general.* (1) The persons referred to in section 267(a) and § 1.267 (a)-1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.